

Portfolio Management For High Net Worth Investors

August 2008



THE MDE GROUP, INC.

Your family's most trusted advisor

PORTFOLIO MANAGEMENT FOR HIGH NET WORTH INVESTORS

Introduction

As a holistic Wealth Management firm for high net worth clients, MDE adds substantial value to our clients in numerous ways, ranging from unique tax minimization techniques to creative planning through aggressive intergenerational wealth transfer. That said, portfolio management arguably remains the most visible service a wealth management firm provides to its clients. In this regard, all advisors have their preferred approach to managing client portfolios and, at a “big picture” level, nearly all of them utilize some form of risk and return metrics in the portfolio management process. However, beneath this “big picture” level many advisors have gravitated towards what we at MDE deem to be outdated or failed portfolio selection models; namely those based on Markowitz Portfolio Theory, Morningstar Style Box Analysis, and New Product Strategy.

In this report, we first discuss why the conventional approaches to managing client portfolios have failed most high net worth investors. We then articulate MDE’s portfolio management process, which rests on a core set of investment principles – “eternal truths” – that are ultimately tailored to precisely meet a client’s unique goals and objectives. In our view, MDE’s innovative portfolio management approach provides a more appropriate decision making framework, with stronger intellectual underpinnings to add long term stability and value to high net worth investors.

Failure of Modern Portfolio Theory

Markowitz Portfolio Theory

Harry Markowitz shared the 1990 Nobel Memorial Prize in Economic Science for his pioneering work in portfolio theory. Prior to Markowitz’s seminal work in the early 1950’s, risk was considered to be of far less importance than return in the portfolio construction process. Furthermore, the mindset prior to Markowitz was that risk was best mitigated by naïve diversification across many securities and not the correlation or interaction approach that played a central role in his theory. In a nutshell, Markowitz created an approach for finding the optimal risk-return combination of all investment possibilities, creating an “efficient frontier” for investing. This model then matched individual preferences to this investment opportunity set in order to tailor a portfolio to a client’s objectives along this efficient frontier. **Figure 1** graphically illustrates Markowitz Portfolio Theory.

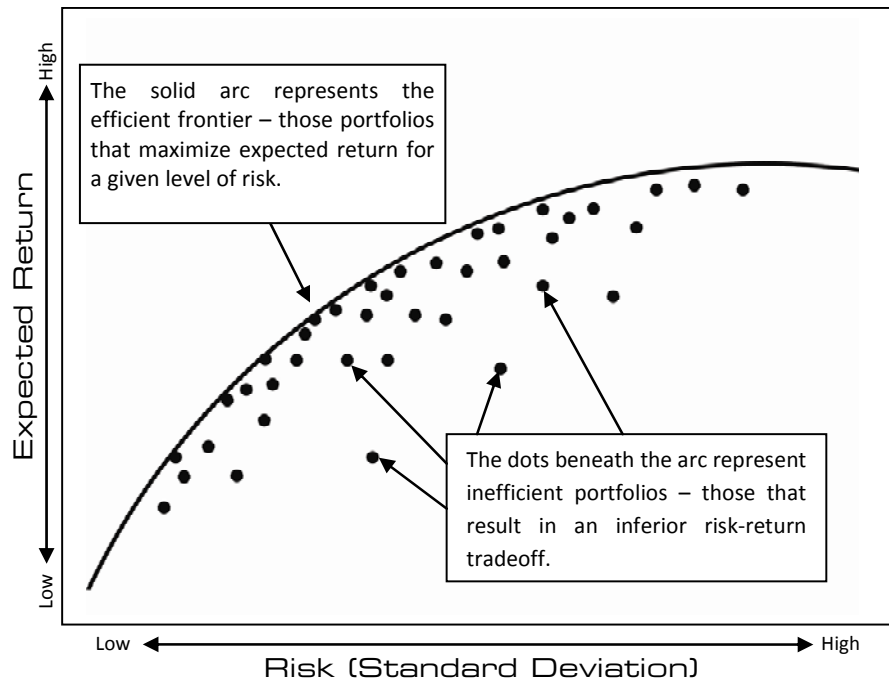
The Markowitz model is an elegant *theory*. However, its utilization in practice yields several short comings.

- First, when the inputs, such as the risk and return estimates for specific securities, and even broad asset classes, change rapidly, the recommended portfolio shifts dramatically. So, the Markowitz optimizer may recommend a portfolio next week or month that is significantly different than the one recommended during the prior period.
- Second, the theory relies heavily on the notion of interaction or correlation. However, during times of market distress correlations of most securities, and many broader asset classes, spike to near one, providing far less downside protection than the theory suggests.
- Third, the traditional methods for estimating the inputs of the model are flawed. One popular approach relies on using all available historical data, which makes it difficult for the model to capture structural changes in the market such as the increase in correlations among securities due to globalization and the near
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universal acceptance of capitalist style economic systems. A second popular approach relies on using the past five to ten years of data and places too much emphasis on recent price movements, resulting in the over emphasis of recent winning investments and under emphasis of recent underperformers. This outcome is contrary to the common sense notion of “buy low, sell high.” Furthermore, the future is often very different from the past, as evidenced by the performance of travel related stocks in the aftermath of 9/11.

- Fourth, the theory assumes that risk and return are all that matters to investors, while in practice a host of other factors, due in part to aspects of investor psychology, play a central role in client satisfaction.

Figure 1: Markowitz Portfolio Theory



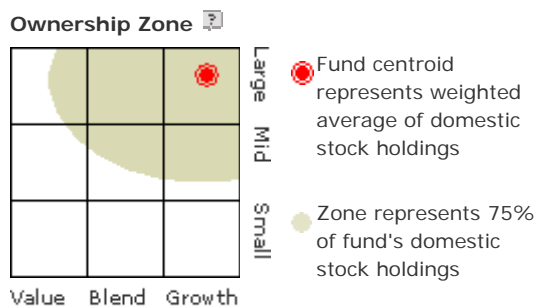
Source: Street Analysis.com

Various enhancements to Markowitz Portfolio Theory have been proposed, but the current state of the theory is that it applies best to “big picture” portfolio items, such as long term asset allocation, and not to the all important task of selecting specific investments for client portfolios or near term portfolio movements.

Morningstar Style Box Analysis

Morningstar, the well-known mutual fund data service provider, played a leading role in popularizing the Style Box. Its use by high profile institutional pension consulting firms further increased its popularity. The Style Box approach looks at an investment from two dimensions, its Size and Style. Size refers to securities of Large, Mid, and Small market capitalization. Style refers to Value, Growth, or Blend, providing an indication of the price of the security relative to its growth prospects. By way of example, the Style Box for the Fidelity Magellan mutual fund is shown in **Figure 2** below. The box indicates that the bulk of the fund’s assets fall in the Large Growth category.

Figure 2: Style Box for the Fidelity Magellan Fund



Source: Morningstar.com

According to the Style Box approach to portfolio construction, investors should have only style specific managers who do not “drift” from one style box to another based upon changing market circumstances informed by their own macro judgment. Since each manager is style specific, investors should have a portion of their funds allocated to each section of the box. This approach provides broad diversification across the market capitalization and valuation spectrums. Investment advisors could nearly always point out to their clients a great performing fund, due to the fact that the market often rotates its focus on a specific segment of the fund industry (e.g. Large Cap Growth in the late 1990s and Small Cap Value from 2003 - 2006).

In our view, Style Boxes are a sub-optimal method of portfolio construction and create a false sense of security. As noted above, market correlations often spike to one during times of distress. Therefore, all segments of the Style Box will likely suffer material losses in the event of a market correction, as in the 2002 market for U.S. equities. Furthermore, fund managers in each box are typically concerned with benchmark risk, or the risk of underperforming their index on a relative basis. This mentality leads to a “benchmark hugging” mindset where a fund would be pleased with a loss of 15% if its benchmark was down 20%. Nearly all individual clients view losing money as the primary metric of risk and not underperformance relative to a long only benchmark. Style Boxes place artificial constraints on managers forcing a Value manager, for example, to hold a sizeable position in financial stocks, even if they were bearish on the entire sector.

At MDE, we believe a better approach is to hire talented managers and give them the freedom to invest wherever – Domestic, International, Large, Small, Growth, Value – they see the greatest opportunities. We also believe strongly in downside protection by complementing long only managers with alternative and hybrid investments rather than simply diversifying across Style Boxes.

New Product Strategy

The New Product Strategy, pejoratively known as the “product pushing strategy,” has the advisor lead with “selling” an intriguing product with little regard to its impact on the risk and return of a client’s overall portfolio. After several “product pushes,” the client typically winds up with a hodgepodge portfolio of “hot investments de jour” that are often on the verge of cooling rapidly. This strategy may work well in the short-term, or in a momentum driven market, but it rarely makes sense for a client’s long-term financial well being. Investors are often susceptible to a sales pitch that discusses recent historical returns, or the past track record of the “smartest managers” or those with “brand names” under the incorrect assumption that past returns will continue into the future. Given the competitive and mean reverting nature of many financial markets, the opposite is often true, with past winners turning into losers and visa versa.

At MDE, we eschew this hodgepodge approach to investing. All client portfolios are based on a long term integrated strategy across the risk spectrum. We often take pride in the innovative investment strategies that we bring to our clients, as part of their integrated portfolios. For example, we are one of the first wealth management firms in the nation to include Planned Return Strategies (PRS) as a core, long term part of our client portfolios. Our clients never hold a hodgepodge of investments and their holdings are reviewed on an ongoing basis to ensure that their portfolio remains appropriate for achieving their long-term goals and objectives.

The Eternal Truth's of Portfolio Management

We have all lived through fads, be they from the popular culture or investment landscapes. Many of us can recall the mania surrounding items such as Pokémon, Cabbage Patch dolls and hula-hoops. On the investment side, the “Nifty Fifty” boom of the early 1970s and dot com mania of the late 1990s immediately comes to mind. Some ideas stand the test of time, while others virtually disappear after the euphoria dies. At MDE, we believe it is prudent to develop a portfolio management process that rests on investment principles that stand the test of time, or what we refer to as the “eternal truths” of portfolio management.

There *is* a Relationship between Risk and Return, *but* It Takes Time

Stocks generally outperform bonds, which generally outperform cash equivalent securities. Each of these investments has outperformed inflation over the long-term. Alternative investments and hybrids generally provide returns between stocks and bonds, although this statement may vary depending upon the riskiness of the specific investment within these additional asset classes. In short, there *is* a historical relationship between risk and return going as far back as we have data (1802 according to data accumulated by Wharton Professor Jeremy Siegel.) The relationship between higher risk and higher return is not a fluke of the data, but rather based on strong logical principles. What rational investor would invest in a higher risk security if he did not expect a higher return? Conversely, if there existed a low risk investment that provided consistent high returns, it would violate our deep-seated intuition that it is impossible to consistently “get rich quick.”

However, there is a catch. It takes time for the relationship to hold. Indeed, the opposite often occurs over relatively short time horizons, with high risk investments providing the lowest returns or largest losses. The market often behaves like a pendulum, overshooting on the upside, then the downside. These phenomena result from the two fundamental yet conflicting elements of human nature, namely fear and greed.

Over any 3-year period of time over the past 20 years, stocks have earned positive returns 87% of the time. Furthermore, equities have outperformed nearly all other asset classes over most 5 year or longer time horizons. There are rare exceptions where stocks lost money over these intervals, such as starting near the peak of the Crash of 1929 or the Internet Bubble. The net takeaway from this principle is that high net worth investors should nearly always have a reasonable allocation to equities, if they have a time horizon of three years or longer. Later in this report, we will discuss MDE’s process for calibrating the percentage of equities in a client’s portfolio versus other asset classes.

No Asset Classes Are Immune to Corrections: Diversification is the Best Antidote for Risk

Risk, by definition, is largely unpredictable. As noted above, over time, we can state that some assets are less risky than others. However, over relatively short periods of time even “safe” investments can exhibit substantial risk. By way of example, Auction Rate Preferred (ARP) securities were considered to be very safe, liquid securities. Many corporations and high net worth investors purchased ARPs as cash equivalent substitutes. However, over the past year, the ARP market has largely seized up. While over time most of these investments are likely to trade at their full face value, over the near term, investors demanding immediate liquidity on their positions suffered double-digit

losses. By way of additional example, in spite of the word “hedge” in their name, most hedge funds lost money during 2008Q1, with the HFRI Fund Weighted Composite down 3.1% over the quarter. As is also obvious to any long term investor, blue chip stocks are clearly not immune from corrections, as evidenced by the current market correction, which has seen the values of venerable financial institutions plummet, and by the 2000-2002 bear market for U.S. equities which saw the performance of one-time market darlings, such as WorldCom, Enron, Tyco, and Lucent nose dive. Lastly, even investments in U.S. Treasury securities may be risky, as evidenced by their performance during high inflationary periods, such as the late 1970s and early 1980s. Individuals owning long-term Treasury securities during this time lost substantial capital if they had to liquidate their positions prior to maturity and lost substantial purchasing power in the event that they held them until the securities matured.

The takeaway from this discussion is that no investment or asset class is always immune from a correction. The nature of market psychology is that the next down cycle will often be led by the investment or asset class that has been bid up disproportionately in recent times. As such, diversification is the best antidote for risk. The degree of diversification depends upon a client’s particular risk tolerance. On the surface, it appears that diversification provides a simple solution to the risk problem. However, many investors have difficulty adhering to a well-grounded plan since they often get impatient with relatively stable hedged investments during bull markets. They tend to abandon these more stable investments after several years of perceived underperformance while not fully taking risk, and the potential for the next market down turn, into account. However, whenever the inevitable downturn in the market comes, investors often question a very high allocation to equities or other higher risk asset classes. In short, the optimal course of action is to be not only well diversified, but also very disciplined, especially in the event of a roaring bull market, since increased risk is likely lurking around the corner.

Effective Market Timing Is Virtually Impossible

Market timing is a tactical strategy where investors attempt to shift between holdings in equities, and cash (or other asset classes) based upon their outlook for whichever asset class has the highest expected return. On the surface, its allure is quite tempting. Consider an investor that had the *perfect foresight* to switch on a monthly basis between whichever asset class – U.S. equities or U.S Treasury Bills – had the highest monthly returns over the January 1926-May 2008 time period. A \$1 investment would have compounded to \$43.3 billion over the nearly eighty-two and one half year time frame with the benefit of perfect timing. This compares to a \$3,123 value for buying and holding the S&P 500 and a \$20.36 value for simply holding Treasury Bills over the same time period.

These astronomical returns due to perfect market timing are largely an illusion, since no one has perfect market timing ability. Somewhat surprisingly, merely missing the 1.5% of months with the highest returns for the S&P 500, would have cut total returns for the buy and hold equity strategy by 93%. If an investor switched to an all cash portfolio during the 6% of months where the S&P 500 experienced its best returns, annual returns would have been cut by nearly 99.8%. Although the reverse logic – being in cash during market downturns – would have similarly improved results, the net takeaway is that consistent, effective market timing is virtually impossible. The best returns in the market are often realized by investing when it is near its lows and investors are panicking. Unfortunately, the opposite is most often true with many investors “capitulating” to the bear market and selling out after having suffered losses thereby creating a market bottom upon which the next bull market can build.

Creating “staying power” to remain invested in the market during a downturn, by maintaining a broadly diversified portfolio, is nearly always the best course of action. The list of great investors - Graham, Buffett, Templeton, Lynch, etc. - is dominated by fundamental investors, or by those who analyze the business prospects and earnings power of companies. Perhaps with the exception of noted hedge fund manager, George Soros, market timers are noticeably absent from an investors “hall of fame.” However, even George Soros has been famous for the magnitude of some of the losses he has suffered due to incorrect market calls. In sum, market timing as a core strategy is likely folly.

Be Aware of Past Market History, but Do Not Be a Slave to It

From a big picture perspective, there is little new under the sun. As noted previously, fear and greed are inextricable parts of human nature, resulting in an eventual boom and bust cycle for many markets. The general pattern may be the same, but the specific circumstances often change. Some noteworthy market events included the Crash of 1929, Oil Embargo triggered 1973-1974 bear market, Crash of 1987, S&L Crisis of the late 1980s, Asian Currency Crisis of 1997, Russian Ruble and Long Term Capital Management events of 1998, Bear Market of 2000-2002 (beset by the effects of the Internet bubble, 9/11, and corporate fraud), and Bear Stearns' near bankruptcy in March 2008 followed by the oil, dollar and credit related sell off in June of 2008. During each of these market panics, it seemed as if the financial world as we know it was coming to an end. But it never does. With the benefit of historical hindsight, the path to recovery from a prior panic now seems clear. However the "way forward" was anything but clear at the time the event was occurring. History never repeats itself completely, so investing by simply looking in the rearview mirror, by extrapolating the past into the future, is doomed to failure. Rather, the inevitable, yet unpredictable course of market disrupting events should reinforce the need for a diversified portfolio and a human touch, supplemented by computer analyses, guiding the investment process.

Putting It All Together: A "Bottoms Up" Portfolio Selection Process

We previously noted some of the problems with typical portfolio construction methods and discussed what we consider to be eternal truths of portfolio management. In our near term view, there is a superior way to construct, monitor and rebalance client portfolios. MDE's approach avoids many of the shortcomings of modern portfolio theory, yet stays consistent to fundamental principles that drive investment returns. We call it a "bottoms up" approach because our initial focus is on the client's goals and objectives, followed by the characteristics of each investment, finally branching out to the portfolio construction and monitoring processes. In contrast, many investment processes, such as the Markowitz and Style Box approaches, start with a view of the world, rely on outdated historical performance and correlation data and then drill down to the security and client specifics. To this end, MDE builds portfolios by understanding how different managers invest and why they perform under various market circumstances. We then blend together a variety of managers who taken together, should provide more consistent performance over time. While this approach may not allow investors to capture all of the upside of a bull market, it will mitigate losses in a market downturn leaving investors with the potential for the inevitable market recovery. In short, MDE's approach focuses on assisting our clients to meet their goals over the long term, not beat artificial and irrelevant market indices over the short term.

MDE's Portfolio Management Process

Custom Tailored Portfolios: The most important benchmarks are those set by our clients. We listen carefully to each client's goals and objectives and ultimately design portfolios that provide the greatest likelihood of achieving these aims over time. Our client-centric portfolio optimization process allows us to integrate investment management with financial planning, asset allocation, and risk control. Careful and detailed qualitative assessment of clients' needs and objectives lead to optimum portfolio construction around long term goals and objectives. We are leaders in applying Behavioral Finance to wealth management. We strive to educate clients when their near term actions or views may be detrimental to achieving their long-term goals and objectives. We always remain objective, leaving emotion out of the decision making process, so as to not overreact to near term market distortions either on the upside or the downside.

Rigorous Risk vs. Return Analysis of Each Investment: We conduct a rigorous risk versus return analysis for each investment that we recommend to our clients. Quantitative risk measures, such as Sharpe Ratio, Sortino Ratio, Upside to Downside Capture, Rolling Returns, Maximum Drawdown, peer ranking, correlations, risk factors, diversification, liquidity, leverage, performance attribution, market exposure, and security characteristics are carefully

analyzed. Furthermore, we conduct highly rigorous qualitative due diligence, including operational execution ability, background checks, investment professional experience, stability and durability of the business model, capacity, investment discipline, risk management systems, infrastructure, conflicts of interest, financial reporting and client service capabilities. We have a strong philosophical bias towards investments that have *low leverage* and high levels of *transparency, liquidity, and tax efficiency*. We effectively utilize the purchasing power of our entire client base to secure *lower fees* than is normally possible for a single high net worth individual to obtain. These lower fees fall directly to the bottom line of client portfolios, resulting in higher net returns.

Construction of a Diversified Portfolio: In depth knowledge of each potential investment is the basic building block for MDE's "bottoms up" approach to the construction of client portfolios. Portfolio weights are determined through a combination of quantitative and qualitative analyses. Quantitative metrics look not only at individual risk measures, such as Upside to Downside Capture, but also interaction measures such as correlation. We fully realize the limitations of correlation analysis and stress test the portfolio by assuming correlations rise sharply during times of market distress. Qualitative analysis ensures that the suggested portfolio is consistent with the broad financial market views of our Investment Committee, which in aggregate consists of professionals with more than one hundred years of investment experience. We utilize a cross selection of unique managers with different return drivers and risk exposures through sophisticated quantitative and qualitative tools. We employ hedge fund like thinking and favor opportunistic manager selection. Our bottom-up portfolio construction process blurs the lines between investment styles and is style-box agnostic. To further reduce the risk of market timing, we often *dollar cost average* large investments of new capital into the market over several periods. Tax planning is part of MDE's DNA so we carefully analyze the *asset location* of each investment in order to minimize the tax impact and maximize the after-tax returns of our recommended portfolios. Finally, the portfolio is stress tested under various potential adverse outcomes and ultimately refined to create a *client specific optimized portfolio*.

Monitoring and Rebalancing: The risk and return characteristics of the initial portfolio will change with the passage of time due to changing prices, fundamentals, and client objectives and constraints. Quantitatively, we monitor changing correlations and risk levels relative to equity and fixed income markets, track the consistency of performance results, and calculate/analyze performance attribution. Qualitatively, we closely watch each manager's capacity to grow, personnel turnover, and the promptness of their service. Our ongoing monitoring includes daily and monthly trade activities, quarterly strategy reviews, and bi-annual on-site visits. Each week, MDE's Investment Committee meets to discuss items and analyzes data impacting our clients' portfolios. Furthermore, MDE's Investment Committee relentlessly searches for the best ideas across the entire investment universe in order to bring the best possible strategies to our clients. Consequently, we are often hiring and terminating investment managers, adjusting portfolio weights, and introducing new investments to our client's portfolios. We continually challenge the status quo and develop new strategies for clients designed for changing environments. The net result is a *continuous process of excellence* in portfolio management.

Conclusion

Modern portfolio theory has failed to deliver on its theoretical promise of a steady path to attractive risk adjusted returns. In our view, a better approach is to build portfolios that rest on eternal principles of investment management, such as the relationship between risk and return, diversification, avoidance of market timing, and knowledge of market history. We strongly prefer investments that have low fees, low leverage, low taxes, high transparency, and high liquidity. We analyze investments not only in isolation, but also with respect to their impact on the risk and return of the overall portfolio. Investment management is inherently a dynamic process, so we regularly monitor and rebalance client portfolios as dictated by changing prices, market conditions, and client objectives and constraints. The net result is a continuous process of excellence in portfolio management delivered directly to our clients.

Your personal Wealth Counselor will contact you to ensure that our process of excellence in portfolio management is customized to fully meet your needs. We encourage you to compare MDE's client centric approach to that followed by many of our wealth management competitors, who often place their interests ahead of their clients. If you have any additional questions in the interim, please do not hesitate to contact us.